Risk Mitigation: Protect Margins and Reduced Risk

Situation: Lack of Risk Control

A company that was highly dependent on the plastics sector of the oil industry failed to correlate the impact oil prices were having on its business. Its practice was to purchase inventory in advance, rather than at the same time it would bid on jobs. So, when commodities markets became very volatile, they ended up losing money because they had paid higher prices for those raw materials than what they could sell their products for when the commodity prices came down.

Approach: Monitoring Materials

KRM helped this company understand the price risks it was taking when it sold its product or purchased inventory and how to hedge against loss.

Using the ‘long/short’ analogy, KRM created a system for the company to monitor its price risk. Inventory on hand (raw materials and in finished product) less the amount of inventory required to fill sales identifies how “long or short” the company is. Knowing this figure helps the company determine the earnings impact from price changes in its inventory. A company that plans to reduce this price risk will devise systems to match its inventory requirements with its booked sales or will develop procurement systems that price its inventory with vendors when it prices sales to its customers.

For example, 1,000 tons of plastic has been purchased at $100 per ton and before any parts were sold, the market price dropped to $50 per ton. A potential customer will expect to pay for the parts based on the current price of plastic, $50, not the cost the supplier paid, $100. This difference can have significant earnings impact. In this scenario, when the company buys inventory without having a sale it is ‘long’ inventory and subject to losses if plastic prices decline. On the reverse, taking a large sales order without having any plastic in stock would’ve put them ‘short’ and subject of losses if plastic prices rise.

There are a number of ways to hedge this risk:

- Wait to buy raw material until product is sold.

- Develop procurement pricing programs that price raw materials when sales are priced.

- Use derivative products (futures, options or swaps) as a proxy for your raw materials.

Results: Lower Costs and Higher Profits

After implementing KRM's Raw Materials Position reporting tool, this company's earnings stabilized and improved, and its costs declined.

With the ability to mitigate price risk, the company was also able to protect itself from possible bankruptcy. This is especially important for any manufacturing company whose percentage of overhead for labor costs is decreasing while the cost for raw materials is increasing.

Having a better handle on its needs today better positioned the company to meet tomorrow's demands and to plan for an even brighter future.